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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA, *Appellant*,

v.

FRANCHISE TAX BOARD, *Appellee*.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

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BRIEF OF COLGATE-PALMOLIVE COMPANY AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT

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QUESTIONS PRESENTED

Whether requiring the income of foreign subsidiaries of a domestic corporation doing business in California to be included in the parent corporation's tax base for determining the income to be apportioned to California for purposes of the California franchise tax is repugnant to the Foreign Commerce and Due Process Clauses of the United States Constitution, and in conflict with well established federal tax policy, when:

1. The foreign subsidiaries are organized and operating exclusively in foreign countries and are not part of a functionally integrated business with the parent and no significant property is transferred between the parent and the foreign subsidiaries; and

2. The inclusion of the foreign subsidiaries' income in the parent's unitary tax base results in a significant distortion of the parent's taxable income and double taxation of the foreign subsidiaries' income through misattribution of that income to California.

TABLE OF CONTENTS

	Page
INTEREST OF *AMICUS CURIAE*	1
SUMMARY OF ARGUMENT	2
ARGUMENT	
California's Use of Formulary Apportionment on a Worldwide Combination Basis Violates the Due Process Clause	3
A. Introduction	3
1. Extraterritorial Taxation Test	4
2. Unitary Business Income Test	5
B. California Is Attempting to Tax Extraterritorial Values	8
CONCLUSION	16

TABLE OF AUTHORITIES

CASES: Page

ASARCO, Inc. v. *Idaho State Tax Comm'n.*, ___ U.S. ___ (decided June 29, 1982) 6, 7, 7, n.6

Bass, Ratcliff & Gretton v. *State Tax Commission*, 266 U.S. 271 (1924) 5

Butler Bros. v. *McColgan*, 315 U.S. 501 (1942) 4, 6, 9, 11, 12, 13, 13, n.12; 14

Chicago Bridge & Iron Company v. *Caterpillar Tractor Co., Illinois Department of Revenue, et al., prob. juris. noted*, ___ U.S. ___, No. 81-349 ..... 3, n.2

Exxon Corp. v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980) 6, 7, 13, n.12; 14

F. W. Woolworth Co. v. *Taxation & Rev. Dept.*, ___ U.S. ___ (decided June 29, 1982) 6, 7, 7, n.6

Hans Rees' Sons, Inc. v. *North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931) 5, 7, 15

Japan Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434 (1979) 15

John Deere Plow Co. v. *Franchise Tax Bd.*, 38 Cal.2d 214, 238 P.2d 569 (1951), *appeal dismissed*, 343 U.S. 939 (1952) 14

Mobil Oil Corp. v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) 4, n.4; 5, 6, 7

Moorman Mfg. Co. v. *Bair*, 437 U.S. 267 (1978) . 5, 14, 15

Norfolk & Western Ry. Co. v. *Missouri State Tax Commission*, 390 U.S. 317 (1968) 5, 9, 15

Superior Oil Co. v. *Franchise Tax Bd.*, 60 Cal.2d 406, 386 P.2d 33 (1963) 9, n.8

Underwood Typewriter Co. v. *Chamberlain*, 254 U.S. 113 (1920) 5

Wisconsin v. *J. C. Penney Co.*, 311 U.S. 435 (1940) .4, n.4

CONSTITUTION OF THE UNITED STATES:

U.S. Const. art. I, § 8, cl. 3 ..... 3, n.2; *passim*

U.S. Const. amend. XIV, § 1 ..... 3, n.2; *passim*

Table of Authorities Continued

Page

STATUTES AND TREATIES:

Internal Revenue Code of 1954, as amended (26 U.S.C.) section 482 ..... 13, n.12

Aussensteuergesetz (Federal Republic of Germany) section 1 ..... 13, n.12

Income Tax Convention between the United States and the Federal Republic of Germany, as amended, Sept. 17, 1965, 16 U.S.T. 1875, T.I.A.S. No. 5920, Article III(2) 13, n.12

BOOKS AND ARTICLES:

Special Report: Spotlight on International Business, Forbes, July 5, 1982, at 127 2

Hellerstein, J. and Hellerstein, W., *State and Local Taxation* (4th ed. 1978) 11, n.11

MISCELLANEOUS:

"IRS Could Better Protect U.S. Tax Interests In Determining The Income Of Multinational Operations" (GGD-81-81, Sept. 30, 1981) 10, n.9

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On Appeal from the Court of Appeal of the State of California for the First Appellate District

BRIEF OF COLGATE-PALMOLIVE COMPANY AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT[1]

INTEREST OF *AMICUS CURIAE*

Amicus, Colgate-Palmolive Company, is engaged primarily in the worldwide production and distribution of household, personal care, and industrial products. *Amicus'* subsidiaries conduct operations in more than 50 foreign countries throughout the world. These foreign operations are substantial. In 1981, for example, they generated revenues of $3.1 billion and accounted for 58.7 percent of the total revenues reported by *amicus* in its

[1] Appellant and appellee have filed letters with the Clerk of this Court consenting generally to the filing of *amicus curiae* briefs in this case.

consolidated financial statements. See *Special Report: Spotlight on International Business*, Forbes, July 5, 1982, at p. 127.

This case is important to *amicus* because *amicus* is confronted with precisely the same issues in California (and in other States) as are presented here. California seeks to tax *amicus* on a worldwide combination basis despite documentary evidence submitted by *amicus* showing that (1) its subsidiaries operating in foreign countries are "discrete business enterprises" not functionally integrated with *amicus*' domestic operations, and (2) the inclusion of the foreign operations in the apportionment calculation results in significant over-attribution of income to California, as well as international multiple taxation.

SUMMARY OF ARGUMENT

Under recent decisions of this Court, California's use of a worldwide apportionment method to determine appellant's California tax liability is a clear violation of due process because appellant and its foreign subsidiaries are not engaged in a "unitary business."

Moreover, even if the operations of appellant and its foreign subsidiaries were viewed as a unitary business, ratable apportionment of their combined income would still be a violation of due process because appellant has established that its foreign subsidiaries' operations were significantly more productive than its domestic operations. Formulary apportionment is predicated on the assumption that each dollar of payroll, property, and sales in the taxing State will generate approximately the same amount of income as each dollar of payroll, property, and sales elsewhere. Where, as here, the taxpayer

demonstrates that its output per dollar of labor cost, property investment, or sales is much greater in foreign countries than it is in the United States, the assumption is no longer valid. In such a case, formulary apportionment will have the impermissible effect of shifting income from the more productive foreign operations to the less productive domestic operations, because formulary apportionment treats *all* of the operations as being *equally* productive.

Because California's apportionment formula does not reflect proven differences in productivity here and abroad, California's taxing structure violates due process by taxing appellant on extraterritorial values that have already been taxed once by the foreign countries in which appellant's subsidiaries conduct their business.[2]

ARGUMENT

CALIFORNIA'S USE OF FORMULARY APPORTIONMENT ON A WORLDWIDE COMBINATION BASIS VIOLATES THE DUE PROCESS CLAUSE

A. *Introduction*

This case tests the constitutionality of California's use of formulary apportionment on a worldwide combination basis (the "Worldwide Combination Method") to deter-

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[2] For the reasons set forth in the Jurisdictional Statement in this case, and the briefs previously filed by the appellant and the United States in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue, et al., prob. juris. noted,* ___ U.S. ___, No. 81-349, California's apportionment method is also a *per se* violation of the Foreign Commerce Clause. The balance of this brief will be devoted to a discussion of issues arising under the Due Process Clause.

mine appellant's California taxable income.[3] Under the Due Process Clause, a nondomiciliary State's use of a formulary apportionment method must pass two tests:[4]

1. *Extraterritorial Taxation Test.* First, a nondomiciliary State may tax a resident corporation[5] only on that portion of the corporation's income that is attributable to the corporation's in-state activities. The nondomiciliary State may not tax "extraterritorial values." *Butler Bros.* v. *McColgan*, 315 U.S. 501, 507 (1942) (hereinafter "*Butler Bros.*").

Thus, in cases involving formulary apportionment, this Court has insisted that there be a "rational relationship between the income attributed to the State and the in-

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[3] Under the Worldwide Combination Method, California, in effect, treated appellant and its foreign subsidiaries as a single corporation. That is, California (1) included all of the income of appellant and its foreign subsidiaries in apportionable income, (2) eliminated intercompany dividends from apportionable income, and (3) apportioned the combined income of the entire affiliated group to California on the basis of apportionment factors that took into account the payroll, property, and sales of appellant and its foreign subsidiaries.

[4] In addition to the two tests discussed in this brief, there must also be a "minimal connection" or "nexus" between the taxpayer's activities and the taxing State. *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-437 (1980); *Wisconsin* v. *J. C. Penney Co.*, 311 U.S. 435, 444-445 (1940). Appellant has agreed in this case that the requisite nexus is present.

[5] As used hereinafter, the term "resident" corporation means a corporation that is doing business within the taxing State, but is organized under the laws of some other State and has its headquarters or commercial domicile in some other State. In this case, appellant is a Delaware corporation with its headquarters in Illinois. (J.A. 6-7) All "J.A." references are to the separately bound Joint Appendix; all "J.S." references are to the Jurisdictional Statement; and all "J.S. App." references are to the appendices thereto.

trastate values of the enterprise." *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-437 (1980) (hereinafter "*Mobil*"). See also *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 272 (1978), and *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission*, 390 U.S. 317, 325 (1968). Where, however, the formula employed by the taxing State attributes to the State "a percentage of income out of all appropriate proportion to the business transacted by the appellant in that state," the result will not be upheld. *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931). The income attributed to the taxing State in such a case is "in no just sense attributable to transactions within" the State (*id.* at 134), and the apportionment method represents nothing more than "a mere effort to reach profits earned elsewhere under the guise of legitimate taxation." *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U.S. 271, 283 (1924).

2. *Unitary Business Income Test.* When a resident corporation conducts a functionally integrated, unitary business both within and without the taxing State, it is difficult to determine the amount of the corporation's income that is generated by the corporation's in-state activities. As this Court noted in *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 121 (1920), the State is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." Accordingly, in cases involving a unitary business, this Court has upheld the use of formulary apportionment (rather than separate accounting) to determine the income subject to tax by the nondomiciliary State. As this Court first stated in *Mobil*, 445 U.S. at 439:

> [T]he linchpin of apportionability in the field of state taxation is the unitary-business principle.

By comparison, income earned "in the course of activities unrelated to the" activities conducted in the taxing State (*i.e.*, income earned by a "discrete business enterprise") may not be taxed. *Mobil*, 445 U.S. at 439. Compare, in this regard, *Mobil; Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980) (hereinafter "*Exxon*"), and *Butler Bros.* (where the income in issue was earned in the course of the taxpayers' unitary businesses, and was, therefore, apportionable) with *ASARCO, Inc.* v. *Idaho State Tax Comm'n.*, ___ U.S. ___ (decided June 29, 1982) (hereinafter "*ASARCO*"), and *F. W. Woolworth Co.* v. *Taxation & Rev. Dept.*, ___ U.S. ___ (decided June 29, 1982) (hereinafter "*Woolworth*") (where the income in issue was not earned in the course of the taxpayers' unitary businesses, and, therefore, was not apportionable).

Appellant claims in this case (J.S. 15-23) that California's use of the Worldwide Combination Method violates both of these due process tests. Insofar as the "unitary business income" test is concerned, appellant asserts that the operations of its foreign subsidiaries constitute "discrete business enterprise[s]" (*Mobil*, 445 U.S. at 439) whose income may not be included in apportionable income. A full analysis of the facts in this case is beyond the scope of this brief. *Amicus* does contend, however, that it is apparent from the opinion below that the California Court of Appeal employed an erroneous legal standard in applying the "unitary business income" test.[6] The unitary

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[6] For example, the Court of Appeal attached no significance to the important fact that there was no "substantial flow of goods" between appellant and its subsidiaries. (See J.S. App. A-14, A-15, A-20.) At the same time, the court attached undue significance to the fact that

business test should now be correctly applied by this Court under the standards laid down in its opinions in *Mobil*, *Exxon*, *ASARCO* and *Woolworth*.

When the proper legal standards are applied, *amicus* believes that appellant will be held not to be engaged in a unitary business with its foreign subsidiaries. However, even if appellant and its foreign subsidiaries were engaged in a unitary business, California's use of the Worldwide Combination Method in this case would still violate the extraterritorial taxation test. For the reasons discussed in Part B, California's use of the Worldwide Combination Method (which takes into account the operations of appellant's foreign subsidiaries) violates this test by attributing an unconstitutionally excessive amount of income to California. The standard three-factor formula cannot work under these circumstances and results in the attribution to California of an amount that is "out of all appropriate proportion to the business transacted by the appellant in" California. *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell*, 283 U.S. at 135.

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appellant and its foreign subsidiaries were engaged in the same type of business, stating (J.S. App. A-15 - A-16):

> Appellant engaged in the same business activities as its subsidiaries. The administrative regulations indicate that a strong inference of a unitary business exists where the taxpayer is engaged in the same type of business. This administrative construction of the California tax laws 'is entitled to great weight, and the courts generally will not depart from [that] construction unless it is clearly erroneous or unauthorized.' [Footnote and citations deleted.]

In so stating, the Court of Appeal obviously applied a legal standard that cannot be squared with this Court's subsequent opinions in *ASARCO* and *Woolworth*.

B. *California Is Attempting to Tax Extraterritorial Values*

Under formulary apportionment, the total income of the unitary business is ratably divided (on the basis of the apportionment factors employed) between the taxing State and all other jurisdictions in which the unitary business is conducted, so that the taxing State receives the same "rate of return" as is earned by the entire business collectively.[7] Thus, where, as here, the traditional three-factor apportionment formula is employed, the taxing State will receive the same amount of income for every dollar of payroll, property, and sales in the State as the entire unitary business earns, on the average, for every dollar of payroll, property, and sales in all locations.

Such a result is constitutionally permissible only if the productivity of the employees, property, and sales in the taxing State is, in fact, approximately equal to the average productivity of all employees, property, and sales throughout the diverse jurisdictions in which the unitary

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[7] This can be demonstrated mathematically. The basic apportionment formula, using a single payroll, property, and sales ("PPS") factor for simplicity, is:

$$\text{unitary income} \times \frac{\text{state PPS}}{\text{total PPS}} = \text{state income}$$

Mathematically, this is equivalent to:

$$\frac{\text{state PPS}}{\text{total PPS}} = \frac{\text{state income}}{\text{unitary income}}$$

The "rate of return" is the ratio of income to the payroll, property, and sales producing that income. The rate of return everywhere will be the same because the foregoing equation can be rewritten:

$$\frac{\text{state income}}{\text{state PPS}} = \frac{\text{unitary income}}{\text{total PPS}}$$

business is conducted. Formulary apportionment works in such a case because, under those circumstances, the factors utilized by the formula fairly measure "the relative contribution of the activities in the . . . [taxing State] to the production of the total unitary income." *Butler Bros.*, 315 U.S. at 509, quoting from the California Supreme Court opinion in that case.

By comparison, where the employees, property, and sales are significantly and consistently more productive in the taxing State than for the entire business as a whole, the formula will always under-attribute income to the State.[8] Conversely, where the employees, property, and sales are significantly and consistently less productive in the taxing State than they are for the entire business as a whole, the formula will always over-attribute income to the State. Such constant and significant over-attribution to the taxing State violates the "extraterritorial taxation" test. As this Court recognized in *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission*, 390 U.S. at 327:

> The facts of life do not neatly lend themselves to the niceties of constitutionalism; but neither does the

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[8] It is for this reason that *taxpayers* have sought to utilize the Worldwide Combination Method in cases where the taxpayer's operations inside the taxing State are more productive than its operations elsewhere. See, *e.g.*, *Superior Oil Co.* v. *Franchise Tax Bd.*, 60 Cal.2d 406, 386 P.2d 33 (1963). In such a case, utilization of the average overall rate of return to compute the tax can substantially reduce the amount of tax liability that the taxpayer would otherwise have. The reason for this result is that the averaging mechanism attributes less taxable income to the taxing State than was actually earned there. The States which utilize the Worldwide Combination Method have presumably concluded that their revenue losses in such cases will be more than offset by their revenue gains in the more common cases described in the next sentence of the text.

> Constitution tolerate any result, however distorted, just because it is the product of a convenient mathematical formula which, in most situations, may produce a tolerable product.

Intolerable distortion results from applying California's Worldwide Combination Method. California seeks to include in its apportionment calculation the operations of appellant's 20 foreign subsidiaries in Western Europe and Latin America. (J.A. 14-15) Similarly, in its proceedings against *amicus*, California seeks to include in its apportionment calculation the operations of *amicus*' subsidiaries in more than 50 foreign countries throughout the world. Wage rates, property costs, market share, gross profit percentages, price controls, rates of inflation, currency fluctuations, and other economic factors affecting profitability vary widely from country to country. When business operations transcend economic and national boundaries, it should come as no surprise that the straightforward application of the standard three-factor formula (as called for under the Worldwide Combination Method) produces distortion and a gross misallocation of income. The formula attributes an *average* rate of return on payroll, property, and sales to *each* jurisdiction, whereas the true rate of return for a particular jurisdiction may be significantly larger or smaller, depending on the relative productivity of the employees, property, and sales in that jurisdiction.[9]

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[9] This point was discussed by Assistant Secretary John E. Chapoton in the Treasury Department's comments on a draft of the GAO report entitled "IRS Could Better Protect U.S. Tax Interests In Determining The Income Of Multinational Corporations" (GGD-81-81, Sept. 30, 1981). The Treasury Department's letter of July 10,

The expert testimony in the present case singled out "lower payroll costs in foreign countries" as the "number one factor" contributing to higher foreign productivity.[10] *Amicus* agrees. For example, in administrative proceedings before the California Franchise Tax Board, *amicus* submitted documentary evidence showing that the 1973 labor cost per converted case of product averaged $.945 for products produced by *amicus* in the United States, but only $.372 for comparable products produced by its subsidiaries operating in foreign countries. Where foreign operations achieve much greater productivity per dollar of payroll than domestic operations, an apportionment formula like California's that treats each dollar of payroll as equally productive will inevitably attribute to the domestic taxing jurisdiction income that was actually earned abroad. This results in "extraterritorial values being taxed."[11] *Butler Bros.*, 315 U.S. at 507.

1981, which is reproduced in Appendix IX to the cited GAO report, states in this regard that:

> In terms of economic rationale, formula apportionment has little merit because a corporation could have an increased tax burden merely as a result of its affiliates becoming more profitable or as a result of paying higher wages in the jurisdiction applying the formula. It therefore does not attempt to achieve the statutory objective of correctly reflecting a taxpayer's income.

[10] J.A. 169. See also J.S. App. A-41 - A-42, which contains a chart entitled "Hourly Earnings Rates Translated into United States Dollars for Wage Earners in Manufacturing Industries" for the years 1967-1969. As shown by the chart on J.S. App. A-43, and the expert testimony at J.A. 169, this difference in wage rates is not offset by greater productivity per man-hour in the United States.

[11] See also Hellerstein, J. and Hellerstein, W., *State and Local Taxation* (4th ed. 1978), in which the authors come to precisely the same conclusion, stating (p. 539):

> The underlying premise of formulary apportionment under the Massachusetts three-factor formula is that (using UDITPA as illustrative), by and large, every dollar of wages or property

In *Butler Bros.*, this Court stated, based on the facts of that case, that (315 U.S. at 509):

> We cannot say that property, payroll, and sales are inappropriate ingredients of an apportionment formula. We agree with the Supreme Court of California that these factors *may* properly be deemed to reflect 'the relative contribution of the activities in the various states to the production of the total unitary income,' so as to allocate to California its just proportion of the profits earned by appellant from this unitary business. [Emphasis supplied.]

Butler Bros., however, involved a domestic wholesale dry goods and general merchandise business with its home office in Chicago and wholesale distributing houses in seven States. The taxpayer in *Butler Bros.* made no attempt to show significant differences in the relative productivity of the employees, property, and sales in the jurisdictions where the business was conducted. The taxpayer simply attempted to prove its California taxable income through separate accounting. Here, however, appellant has shown that its business in California and the other States was far less productive than the businesses

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spent in one taxing jurisdiction, along with receipts from sales in the area, will produce the same amount of profit in all taxing jurisdictions. Wide disparities in unit labor or unit property costs between taxing jurisdictions tend to attribute to the high wage-property cost jurisdictions, such as the United States, income which is attributable to other jurisdictions. A margin of tolerance for disparities in wage and property costs has been found constitutionally acceptable in the operation of apportionment formulas, as applied to interstate business, in view of the judicial recognition that any method of division of income is at best an approximation. . . . But once the differences exceed any reasonable measure of tolerance, the application of the formula ought to be vulnerable to constitutional challenge, unless the State grants a variation from the standard formula under the relief provision of the statute. [Citations deleted.]

of its foreign subsidiaries. (J.S. 18-20) Consequently, the Worldwide Combination Method cannot "properly be deemed" in this case to measure the "relative contribution" of appellant's California activities. See *Butler Bros.*, 315 U.S. at 509. Under these circumstances, it is entirely appropriate to use the internationally accepted arm's-length separate accounting method as a means of measuring the difference in profitability attributable to the independently established difference in productivity.[12]

The opinion below does not come to grips with appellant's argument that failure to reflect differences in productivity causes constitutionally unacceptable distortion. In this regard, the Court of Appeal stated (J.S. App. A-20):

> Appellant asserts that the application of the apportionment formula to foreign subsidiaries fails to account for different wages, property costs and returns on sales. Appellant recognizes that there are variations in wages, property costs and returns on sales within the United States, but argues that the wholly different nature of the elements in foreign countries creates an unreasonable result. Variations in profitability within the United States have not

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[12] Such arm's-length separate accounting computations (as contrasted with the internal audit results at issue in *Butler Bros.* and *Exxon*) are required by the laws of the United States and the foreign countries involved, and also by treaties between the United States and many foreign countries. See, *e.g.*, Internal Revenue Code of 1954, section 482; section 1 of the Aussensteuergesetz (Federal Republic of Germany); Art. III(2) of the Income Tax Convention between the United States and the Federal Republic of Germany, as amended, Sept. 17, 1965, 16 U.S.T. 1875, T.I.A.S. No. 5920. These separate accounting results are subject to review by the tax authorities in the countries involved (see, *e.g.*, J.A. 78) and because those authorities have competing interests, their findings cannot be lightly dismissed.

> precluded apportionment of income according to an appropriate formula. [*John Deere Plow Co.* v. *Franchise Tax Bd.*, 38 Cal.2d 214, 238 P.2d 569 (1951), *appeal dismissed*, 343 U.S. 939 (1952)] Where a company is engaged in a unitary business, a state may apply an apportionment formula to the taxpayer's total income to arrive at a rough approximation of the corporate income attributable to activities within the state. [*Exxon*, 447 U.S. at 223; *Moorman Mfg. Co.* v. *Bair*, 437 U.S. at 273]

Because the court made no effort to evaluate the degree of distortion in this case, its statement constitutes a categorical rejection, as a matter of law, of appellant's productivity argument—regardless of how aggravated the resulting distortion may be—and is grounds for reversal by this Court.

Amicus disagrees with the reasoning and the result in *John Deere Plow Co.* v. *Franchise Tax Bd.*, 38 Cal.2d 214, 238 P.2d 569 (1951), *appeal dismissed*, 343 U.S. 939 (1952). Moreover, that case, like *Butler Bros.*, involved a business conducted wholly within the United States. The acceptance of the three-factor formula in such wholly domestic cases cannot properly be parlayed into a blanket, automatic acceptance of the formula in all cases—especially those where the asserted unitary business also is conducted, in part, in many different foreign countries with widely different economies. In such cases, economic conditions (such as labor rates, inflation rates, currency fluctuations and the like) will generally vary more widely than they will in a wholly domestic context. Accordingly, there is a far greater risk that the three-factor formula will over-attribute income to the United States by a significant amount. The consequences of such distortion are particularly severe, and the Due Process Clause prohibition on extraterritorial taxation should therefore be enforced with particular vigor, where, as here (J.S. 10-11),

the State is seeking to use formulary apportionment as a means of taxing income that has demonstrably been taxed abroad. *Cf. Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 446-451, 455-456 (1979).

Amicus recognizes that precision is impossible when formulary apportionment is utilized to determine the amount of income attributable to activities in the taxing State. See *Moorman Mfg. Co.* v. *Bair*, 437 U.S. at 273. Obviously, some divergence is to be expected between the actual productivity in the taxing State and the average productivity of the entire unitary business. Nevertheless, despite the constitutional acceptability of occasional over-reflection or under-reflection of income, this Court also reiterated in *Moorman Mfg. Co.* v. *Bair*, 437 U.S. at 274, that a "formula-produced assessment" will not be permitted—

> when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportion to the business transacted . . . in that State,' [*Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell*, 283 U.S. at 135], or has 'led to a grossly distorted result,' [*Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission*, 390 U.S. at 326].

This is such a case.

CONCLUSION

For the foregoing reasons, this Court should reverse the decision below. If, however, this Court upholds the constitutionality of California's Worldwide Combination Method as applied to the facts of this case, *amicus* respectfully requests that the Court state in its opinion that the Worldwide Combination Method will, nonetheless, be held unconstitutional if (1) the taxpayer is not conducting a functionally integrated, unitary business with its foreign affiliates, or (2) the use of the Worldwide Combination Method results in significant distortion and the over-attribution of income to the taxing State.

Respectfully submitted,

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